

**Testimony of
The National Grain Trade Council
On Reauthorization of the Commodity Futures Trading Commission**

**Before the Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives**

March 9, 2005

Mr. Chairman and Members of the Subcommittee:

Good morning. My name is George Hanley and I am president of Hanley Group based in Chicago, Illinois. I also am a member of the National Grain Trade Council (the Council) on whose behalf I appear before you this morning. The Council is a North American trade association that brings together grain exchanges, boards of trade, and national grain marketing organizations with their grain industry counterparts including grain companies, millers and processors, railroads, futures commission merchants, and banks. The Council's mix of membership provides it with a unique perspective on futures trading issues, such as reauthorization of the Commodity Futures Trading Commission. We have shared our expertise in this arena with you on numerous occasions in the past and we welcome the opportunity to do so again today.

As an overview of our testimony, the National Grain Trade Council supports the movement from prescriptive regulation to the core principles of the Commodity Futures Modernization Act of 2000 (CFMA). The Council and its members are very pleased with how the CFMA has been implemented and the industry has prospered under it. Since 2000, the futures industry has experienced strong growth in volume and in the types of products available. The CFMA ushered in an environment that allows for advances in technology, such as electronic trading, that would not have occurred as efficiently or as rapidly under more restrictive regulation and oversight. In general, the Council views the CFMA as very effective at achieving its goals.

The Council strongly believes that price discovery, the fundamental goal of a regulatory structure, is best accomplished by vesting responsibility with exchanges and providing the Commodity Futures Trading Commission (CFTC) with the necessary tools for oversight authority and meaningful regulation. In the spirit of the CFMA, we advocate leveling the playing field between agricultural commodities and other physical commodities. The Council believes that enumerating agricultural commodities no longer advances the public policy goals originally envisioned.

When discussing meaningful regulation, we make several recommendations regarding approval for increases of speculative position limits, the agricultural trade options program, and the application process for new contract markets. Finally, the Council would like to draw your attention to the negative impact Financial Accounting Statement 133 is having on commodity markets.

Equitable Treatment for Agricultural Commodities

The Council believes that enumerating agricultural commodities under the CFMA no longer serves to advance public policy. Agricultural markets have matured, especially under the CFMA, and the more prescriptive regulation is no longer necessary to protect the markets or the market participants. Modern US agricultural futures and options markets are much deeper, draw significant representation from worldwide commercial hedging interests, and offer greater trading opportunities for a speculative community whose participation is as essential for the success of our markets as farmer and commercial hedging communities. Trading volume is high and growing each year – testimony to the solid connection between US exchange prices and the underlying prices of domestic and internationally traded physical commodities. As the CFTC moves toward becoming more of an oversight authority under the CFMA, Congress may want to consider whether the regulatory structure should recognize the maturity of the agricultural markets and put them on parity with the other physical commodity markets.

Speculative Position Limits

The Council supports the petitions of the Chicago Board of Trade, the Kansas City Board of Trade, and the Minneapolis Grain Exchange for repeal or amendment of speculative position limits. The Council strongly believes that exchanges should be responsible for setting speculative position limits, subject to the Commission's oversight; however, if federal speculative position limits are retained, the Council supports increasing the limits and the maintenance of parity across wheat exchanges.

By eliminating federal speculative position limits, the Council believes two goals would be accomplished: 1) reduction in duplicative regulatory oversight and 2) greater market transparency. Core Principle 5(d) of the CFMA requires boards of trade to adopt position limits where necessary and appropriate, subject to the oversight of the CFTC; however, a small subset of agricultural commodities continue to be subject to the jurisdiction of the CFTC.

Currently, exchanges must go through the self-regulatory process to change their rules to allow for an increase in limits. Then, they must petition the CFTC to modify its rules to permit such an increase. This duplicative regulatory structure is different from other contracts and different even from other agricultural contracts. Elimination of the regulatory redundancy would fully implement the core principals of the CFMA for all agricultural commodities and allow exchanges to respond quickly to the ever-changing market conditions, while retaining CFTC oversight. The CFMA pushes the regulatory structure to permit greater self-regulation of the markets. Allowing exchanges to set speculative position limits, subject to the guidelines and oversight of the CFTC, is part of achieving that goal.

Furthermore, allowing exchanges to increase speculative position limits would also increase activity in a transparent marketplace and allow exchanges to compete more efficiently with over-the-counter markets. If a transaction exceeds the current limits, the transaction moves off-exchange, to a less transparent market. The Council strongly believes that streamlining the process helps all market participants at all levels by increasing activity in a transparent marketplace and increasing liquidity.

We would also like to bring to your attention our concern that funds are taking a position in agricultural indexes of sufficient size to justify petitioning the CFTC for a hedge exemption. In our view, this has the potential to present a misleading perception of commercial participation versus speculative participation in agriculture markets. As this issue moves forward, we believe the definition of a commercial participant should be carefully assessed.

Agricultural Trade Options

Another issue that warrants further review by the CFTC is the agricultural trade options (ATO) pilot program. The Council supports the comments of Acting Chairman Brown-Hruska¹ on the need to make viable risk-management tools, like ATOs, available for producers.

Under the ATO pilot program, only one entity has registered as an ATO merchant, and according to Commission records, this merchant enters into a small number of options each year. The program has not met the expectations of producers, industry or the CFTC. We commend Acting Chairman Brown-Hruska for being open to revitalizing the program. Over the years, the Council has watched the CFTC and industry wrestle with ideas on how to make the ATO program more productive, but at this point, the Council does not believe that the existing framework is workable.

Instead, the Council believes that now is the time to consider a fresh start. Over the last four years, the industry has seen remarkable innovation in the energy and metals markets. Products continue to improve and the industry continues to develop better tools for managing risk. The Council suggests tapping into that innovation and putting it to work to deliver a risk management tool for producers that is both valuable and effective. In our view, before such tools can be developed, the CFTC and the industry must begin by defining the pool of potential market participants, including examining who should be a commercial participant and what is the appropriate level of creditworthiness.

The Council, working in concert with you, the CFTC, industry and other affected parties is eager to develop such a program.

Application Transparency

The Council champions market competitiveness but believes that transparency is an essential element when introducing new exchanges to the market. We, like the CFTC, believe that it is

¹ Sharon Brown-Hruska, "The Future of Futures" (February 3, 2005) *available at* <http://www.cftc.gov>; "National Grain and Feed Association Seminar on Trading, Trade Rules, and Dispute Resolution" (May 4, 2004) *available at* <http://www.cftc.gov>. "While the utility of [agricultural trade options] is clear, we have a regulatory program that is perceived by practically all elevator operators and other potential agricultural trade option merchants to be too burdensome to be worth the effort to offer the instruments. . . [E]ven as agriculture, and the grain trade specifically, have to contend with increased global competition, and with price volatility and the uncertainty that comes with it, some of the more useful innovations, risk management products, and technologies that have been developed and are widely in use in other industry sectors have not been offered and remain unavailable to the agricultural community. . . Since becoming a Commissioner at the CFTC, what has concerned me more than anything is the lack of availability of such products in the OTC markets that would work for the agriculture industry."

imperative that the regulatory framework seeks to prevent market manipulation, protect customers, provide financial integrity and promote market transparency. To ensure this is accomplished, we believe the application review process for a new exchange must be informed, deliberative, complete and accurate.

The CFMA lowered many regulatory hurdles, making it easier for new entrants to participate in the marketplace. Over the last four years, the market and the CFTC have had an opportunity to adjust to the regime change. Now is the time to draw from our experiences and examine the application process for new exchanges to ensure that there is enough opportunity for discussion and debate. Business plans and marketing today are dramatically different than when many of our existing exchanges originally registered. The Council believes that the application process should ensure that the CFTC, the marketplace and the public receive full and consistent information about new applicants.

FAS 133

Though we understand that financial accounting statements are outside the jurisdiction of the CFTC, the Council believes that it is important to bring to your attention the negative impact Financial Accounting Statement 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, is having on the commodity markets. Under FAS 133, financial firms are allowed to hedge various components that determine a financial asset's price. Allowing agricultural commodity hedgers to hedge components of a finished product would promote greater market participation and more accurate reporting of financial condition.

FAS 133 requires a grain or food processor to report, under certain market conditions, the interim gains or losses from the futures hedge, but it may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument has no relation to the movement of the price of the physical commodity that was hedged². This occurs primarily because FAS 133 prohibits grain processors from hedging components of non-financial assets. Grain processors often hedge one or more ingredients of a finished product that they purchase and use in their manufacturing process, not the finished product itself. This is done because there may not be a viable way to hedge every ingredient of the finished product or prices of certain components of the finished product may be set by an agreement with the supplier. By comparison, financial firms are allowed to designate whether they are hedging the interest rate risk component or credit risk component of a financial asset or liability.

Decades of experience have shown that the Financial Accounting Standard Board's (FASB) assumption that the price of the hedge instrument has no relation to the movement of the price of the physical commodity is incorrect. Properly constructed hedges significantly reduce risk for a processor or other user of grain. The demand for such hedges underlies the health of the entire

² For example, a grain processor might in January enter into a cash transaction calling for physical delivery to occur in June, employing an offsetting futures market hedge transaction in a July futures contract. Under FAS 133, the processor must report the interim gains or losses from the futures hedge, but may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument (in this case, July futures) has no relation to the movement of the price of the physical commodity that was hedged.

US grain marketing system, from country elevators publishing daily bids to farmers for cash delivery of grain for daily, weekly and monthly calendar positions in some cases more than a year in the future, to grain processors and livestock producers who depend on the ability to price commodity inputs accurately in spot and forward markets. Any accounting standard that interrupts this tested system diminishes marketing opportunities for farmers, increases risk for grain handlers and consumers across the marketing spectrum, and reduces participation and liquidity in futures and options markets, to the detriment of all participants.

The negative effects of FAS 133 on the futures market are real. Grain and food processors must either misrepresent their financial state to comply with FAS 133 or opt to not participate in the market. Many firms without the internal expertise or staff necessary to deal with the onerous rules have simply opted to avoid hedging, thus increasing their risks and limiting business for the hedging community. Either result, misrepresentation of financial condition or inhibiting market participation, is an undesirable outcome.

The Council, in conjunction with other industry groups, has petitioned the FASB to make changes but, so far, our efforts have been unsuccessful. To rectify this problem, we have asked FASB to grant agricultural commodity hedgers the same ability granted to financial hedgers. The Council would welcome the opportunity to discuss this issue with you in greater detail.

Conclusion

In conclusion, Mr. Chairman, we compliment you and Mr. Etheridge for your efforts. The Council supports the advances made under the CFMA. We are very pleased with the direction in which we are headed and look forward to working with you on solutions that continue to push the industry toward ever more efficient and meaningful regulation.